In the Matter of the Application regarding the Conversion of Premera Blue Cross and its Affiliates

Washington State Insurance Commissioner: Docket No. G02-45

SUPPLEMENTAL REPORT

of

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March 5, 2004

This Supplemental Report summarizes my additional conclusions relative to certain matters of Washington law and practice that have arisen in connection with the above-referenced application for the conversion of PREMERA, a Washington miscellaneous not-for-profit corporation ("PREMERA"), Premera Blue Cross, a Washington not-for-profit corporation ("Premera BC" and, together with PREMERA, "Premera"), and various of their affiliates from not-for-profit to for-profit status under Washington law (as amended pursuant to the Amended Form A Filing (as defined below), the "Proposed Conversion"), subsequent to November 10, 2003, the date of my initial report (the "Initial Report") to the Office of the Insurance Commissioner of the State of Washington ("OIC"), which report is incorporated by reference herein. The Proposed Conversion is more particularly described in the Amended Form A (Statement Regarding the Acquisition of Control of a Domestic Health Carrier and a Domestic Insurer), filed by New PREMERA Corp. ("New PREMERA") with the Office of the Insurance Commissioner of the State of Washington ("OIC") on February 5, 2004, and the supplementary materials filed by New PREMERA as part of the same Amended Form A submission on February 5, 2004 (the Amended Form A, together with the supplementary submissions to the OIC, being referred to herein as the "Amended Form A Filing").

Materials Reviewed

In formulating the conclusions expressed herein, I have reviewed and relied upon various additional materials and other information made available to me, as described on attached Schedule A.[1]

Qualifications for Conclusions Expressed

A summary of my qualifications is set forth in the Initial Report.

As stated in the Initial Report, other than my engagement to offer my independent conclusions as to the matters addressed in this Report, neither I nor my law firm has any legal representation relationship with Premera BC, PREMERA, any of their existing affiliated entities, or any of the entities-to-be-formed that are identified in the Amended Form A Filing as parties to the Proposed Conversion.

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[1] I have also reviewed various materials relating to the similar proceedings pending before the Alaska Division of Insurance. I expect to address those materials in a separate supplemental report that will be filed in the Alaska proceedings.

Conclusions as to Certain Matters of Washington Law and Practice

The supplemental report from Cantilo & Bennett, LLP ("C&B") concerning the Amended Form A Filing, dated February 27, 2004 (the "C&B Supplemental Report"), the updated report from The Blackstone Group L.P. ("Blackstone" and, together with C&B, the "OIC Consultants") concerning the Amended Form A Filing, dated February 27, 2004 (the "Blackstone Report"), the legal opinions issued by C&B to the Deputy Insurance Commissioner of the OIC on (i) February 19, 2004 concerning the proposed allocation of the assets between Alaska and Washington as a result of the Proposed Conversion (the "February 2004 C&B Legal Opinion") and (ii) January 16, 2004 concerning the State of Oregon's assertion that it is entitled to a portion of the Premera assets and the effect of this assertion on the proposed allocation of the assets between Alaska and Washington (the "January 2004 C&B Legal Opinion" and, together with the February 2004 C&B Legal Opinion, the "C&B Legal Opinions"), the deposition of Patrick H. Cantilo taken December 1-2, 2003 (the "Cantilo Deposition"), and the amended transaction documents included in the Amended Form A Filing, have raised a number of questions as to whether certain aspects of the Amended Form A Filing are in compliance with Washington laws applicable to corporations and with Federal securities law and practice. I address several of those questions below.

Analysis of Charitable Trust Issues

In my view, the most important legal issue that arises in connection with the Amended Form A Filing is whether Premera is a charitable corporation and/or whether its assets should be impressed with a charitable trust. The OIC Consultants expressly base many of their arguments and criticisms on the premise that Premera's assets are subject to charitable restrictions.[2] However, as critical as this threshold

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[2] For example, in the C&B Legal Opinions and the C&B Supplemental Report, C&B bases its legal analysis regarding the allocation of the proceeds from the Proposed Conversion on the assumption that Premera is charitable and that its assets are impressed with a charitable trust. According to C&B and the other OIC Consultants, if a charitable trust is shown, then it follows that, among other things, (i) the assets of Premera need to be "safeguarded" by the attorneys general of the State of Washington and the State of Alaska for the benefit of their respective citizens, (ii) all assets of Premera must be distributed to Washington Foundation Shareholder, a Washington not-for-profit corporation (the "Washington Foundation Shareholder"), and Alaska Health Foundation, an Alaska nonprofit corporation (the "Alaska Foundation Shareholder" and, together with the Washington Foundation Shareholder, the "Foundation Shareholders"), in the Proposed Conversion, (iii) Premera owes a duty to maximize the fair market value of such distributed assets, (iv) no funds received by the Foundation Shareholders may be used to pay administrative or other fees required to effect the Proposed Conversion, and (v) Premera cannot place excessive restrictions and limitations on the Foundation Shareholders and the proceeds resulting from the sale of New PREMERA stock.

issue is to any legal analysis of the Proposed Conversion, neither of the OIC Consultants have devoted any research or analysis to the question in their reports. Instead, they indicate in their submissions that they are simply "assuming" the existence of charitable restrictions, offering nothing to support even the appropriateness of making such an assumption.[3]

This "assumption" as to the existence of charitable trust restrictions is surprisingly cavalier where such a fundamental threshold issue is involved. More importantly, however, the OIC Consultants' assumptions in this regard are unwarranted and quite inappropriate in a proceeding such as this, which involves important business and public policy considerations. The decision not to offer any support for the assertion that Premera's assets are subject to a charitable trust—and instead to merely "assume" this troublesome question away—appears to me to be a conscious choice made for the purpose of supporting a predetermined outcome, rather than the outcome to which a proper legal analysis would lead.[4]

As I discuss below in this Supplemental Report, everything that I have reviewed leads me to believe that Premera is primarily a commercial enterprise that would be difficult to classify as a charitable organization under applicable principles of Washington law. Charitable trust status of a not-for-profit corporation in Washington cannot simply be presumed, either by a Washington court or by the Washington Attorney General or the OIC. Under Washington law, not-for-profit corporations are not

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[3] See, e.g., February 2004 C&B Legal Opinion, Exhibit A at 1 ("C&B understands, and assumes for purposes of this Memorandum, the parties are in agreement that <u>all</u> of the assets of PREMERA should be deemed to be charitable…." and "there is no disagreement among the parties (including PREMERA) that the value of PREMERA must be paid to the public as part of the conversion."). In the C&B Supplemental Report, C&B claims, among other things, that (i) Premera "appeared" to be in agreement that it "must deliver to the citizens of the states of Washington and Alaska" the fair market value of its assets (at 2), (ii) Premera "faces" charitable trust obligations in Washington and Alaska (n.36 at 12), and (iii) the parties "assume" that Premera must satisfy "charitable trust obligations" in Washington and Alaska as a condition to the Proposed Conversion (at 77). From the materials I have reviewed, however, it is apparent that Premera vigorously rejects this assertion and characterization. See, e.g., Cantilo Deposition at 38-39, 71-73, 106-09; Letter from Robert B. Mitchell, Att'y, Preston Gates & Ellis LLP, to John F. Hamje, AIRC, Staff Att'y, Legal Affairs Div., OIC, ex. 7 at 3 (Oct. 15, 2003) (on file with the OIC) ("Contrary to [C&B's] apparent premise, Premera is not a charity."); and Letter from H.R. Brereton Barlow, Chief Executive Officer, and Yori Milo, Executive Vice President, Chief Legal & Public Policy Officer, Premera, to Honorable Christine O. Gregoire, Wash. Att'y Gen. 2 (May 30, 2002) (on file with Wash. Att'y Gen.) ("Premera and its predecessor companies were not established or operated as charitable institutions….").

[4] The only support that C&B gives for its assertion that Premera's assets should be subject to a charitable trust is the equally questionable assertion that "typically" other jurisdictions have so ruled in other BCBS conversions (see C&B Supplemental Report at 3). C&B does not provide an analysis of the facts and rulings from other jurisdictions, and my own analysis of the judicial decisions that are available on the charitable trust issue does not support this assertion either.

automatically deemed to be charities or charitable in nature. Washington courts will not lightly apply the charitable trust doctrine to the assets of a not-for-profit corporation, but will instead require a clear showing that the assets were "received" by the not-for-profit corporation subject to a restriction requiring them to be utilized for a particular charitable purpose. Absent such a showing, which has certainly not been made in these proceedings, the assets of a not-for-profit corporation such as Premera are simply not, under Washington law, subject to either a charitable trust or to the "charitable trust"-like transfer limitations of Washington's not-for-profit corporations statute.

1. Premera's status as a not-for-profit corporation does not automatically render it a charitable corporation or cause its assets to be impressed with a charitable trust under Washington law.

a. *Distinction Between Charitable Corporations, Not-For-Profit Corporations and Public Benefit Corporations*. Contrary to the conclusions set forth in the C&B Supplemental Report and the C&B Legal Opinions, Washington not-for-profit corporations are not automatically deemed to be charities or charitable in nature.[5] In 1969, the Washington Legislature adopted a new not-for-profit corporations act (RCW Ch. 24.03).[6] That new statute did not recognize the concept of a charitable corporation. Almost twenty years after Washington's adoption of the 1964 Model Act, the drafters of the 1987 Model Act recognized that certain "public benefit corporations" may be charitable in nature.[7] However, the Washington Legislature has never adopted this concept, and has instead subsequently

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[5] Swedish Hosp. of Seattle, et. al. v. Dep't of Labor & Industries, 26 Wn.2d 819, 831, 176 P.2d 429, 435 (1947) ("There is a wide distinction in this state between these two kinds of organizations; charitable institutions are to be incorporated under Sec. 3863, and not-for-profit corporations are required to conform to Sec. 3888 of Rem.Rev.Stat.…"); Adult Student Hous., Inc. v. State of Wash., 41 Wn. App. 583, 593, 705 P.2d 793, 798 (1985) (holding that being a not-for-profit corporation "does not alone make a corporation benevolent or charitable."); Adolescent Treatment Services v. Ahvakana ("Adolescent Treatment"), 1999 WL 1034515 (Wash. Ct. App. 1999) (holding that a not-for-profit corporation "is not a charitable trust. As a corporation, its powers are defined by RCW 24.03."). These rulings by the Washington courts are consistent with the structure of Ch. 24.03. If all Washington not-for-profit corporations were considered charitable trusts, there would certainly be no need for the precision found in RCW 24.03.225 relative to differences in disposition of charitable assets versus non-charitable assets upon dissolution.

[6] Under RCW 24.03.005, a not-for-profit corporation is defined simply as a corporation that has no part of its income distributable to its members, directors or officers. RCW Ch. 24.03 is based on the Model Non-Profit Corporation Act of 1964 (the "1964 Model Act").

[7] The Model Non-Profit Corporation Act of 1987 (the "1987 Model Act") classifies not-for-profit organizations into three major categories: "public benefit," religious and "mutual benefit" corporations. A "public benefit corporation" is one that is organized for a public or charitable purpose and that, upon dissolution, must distribute its assets to the U.S., a state, or an entity or person that is exempt under 26 U.S.C. Sec. 501(c)(3).

adopted its own very narrow definition of a "public benefit nonprofit corporation." Under the Washington Legislature's definition, only those not-for-profit corporations that are tax exempt under 26 U.S.C. Sec. 501(c)(3) may hold themselves out "as operating to benefit the public."[8] This very narrow definition evidences the Legislature's view that not all not-for-profit corporations—and in fact only 501(c)(3) corporations—should be considered to be charitable or public benefit organizations under Washington law. This limitation is logical because the eligibility criteria under 501(c)(3) are basically the same as those comprising the common law definition of a charity. Since neither PREMERA nor Premera BC is now or has ever been eligible for tax-exempt status under Sec. 501(c)(3), they are not "public benefit nonprofit corporations" under Washington law.

b. *Charitable Trust Status of a Not-For-Profit Corporation Cannot Simply be Presumed by a Court or by the OIC.* The Washington Legislature's narrow view as to which not-for-profit corporations should be deemed to be operating for the public benefit is consistent with other Washington law relating to the imposition of charitable trust restrictions. I am not aware of any reported case in Washington that has imposed a charitable trust on the assets of a not-for-profit corporation, and what little case law exists in Washington as to "charitable" status arises in very different contexts.[9] Leaving aside the academic debate as to whether charitable trust concepts even can be applied to a modern not-for-profit corporation,[10] I believe that if a Washington court were to consider doing so, it would require a clear

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[8] RCW 24.03.005(14), adopted in 1989. See RCW 24.03.490, cmt. ("The legislature finds that it is in the public interest to increase the level of accountability to the public of nonprofit corporations through…a clear definition of those nonprofit corporations that may hold themselves out as operating to benefit the public.").

[9] Washington courts have historically struggled with the boundaries of "charitable" status of not-for-profit corporations (particularly those engaged in commercial operations), in various contexts other than the imposition of a charitable trust. See, e.g., Susman v. Young Men's Christian Ass'n of Seattle, 101 Wn. 487, 493, 172 P. 554, 556 (1918) (holding that a charitable corporation claiming immunity from liability must not only engage in activities "tending to the betterment of mankind," but it must do so "without gain or the anticipation of gain," and if it "renders no services except those for which it receives an adequate reward, it is a business, not a charitable, concern…."). But see Virginia Mason Hosp. Ass'n v. Larson, 9 Wn.2d 284, 114 P.2d 976 (1941) (stating, in an unemployment compensation context, that "the exaction of compensation for services rendered does not, of itself, deprive an institution of its charitable status.").

[10] There is some argument as to whether the charitable trust concept, as applied to not-for-profit corporations, even exists in the State of Washington. See, e.g., Adolescent Treatment, 1999 WL 1034515 (holding that a not-for-profit corporation "is not a charitable trust. As a corporation, its powers are defined by RCW 24.03."). See also Lundberg v. Coleman ("Lundberg"), 115 Wn. App. 172, 60 P.3d 595 (2002). The courts of other states, following the adoption of not-for-profit corporation statutes, have generally ruled that not-for-profit corporations are governed by corporate, not trust, standards. See, e.g., Health Midwest v. Kline ("Health Midwest"), 2003 WL 328845, and Kansas East Conference of United Methodist Church, Inc. v. Bethany Medical Center, Inc., 266 Kan. 366, 969 P.2d
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showing of not only the "charitable" nature of the corporation's activities, but also an intent by the donor of the corporation's assets that they be utilized for charitable purposes (or, conversely, that they not be used for non-charitable purposes).[11] Because a finding that a charitable trust exists would have the effect of imposing severe restrictions on the use and transfer of property, I do not believe that such a restrictive legal status can be assumed or even presumed, and may only be imposed after a strong showing supported by factual evidence of charitable purpose and intent.

The predominant importance of the donor's intent under Washington law is reinforced by the language of RCW 24.03.225(3), which provides that, upon dissolution of a not-for-profit corporation, any assets that were "received and held by the corporation subject to limitations permitting their use only for charitable, religious…benevolent…or similar purposes…shall be transferred or conveyed to one or more domestic or foreign corporations, societies or organizations engaged in activities substantially similar to those of the dissolving corporation." This statute's careful restriction of "charitable trust"-like transfer limitations to those assets that were "received" by the not-for-profit corporation subject to explicit charitable use limitations is consistent with and supportive of the view expressed above that Washington courts would, in any event, require a clear showing of the donor's intent to impose charitable use restrictions on corporate assets. Although Washington courts have not ruled on the application of this dissolution provision, most cases from other jurisdictions have interpreted its language to require a showing of the donor's restrictive intent before "charitable trust" transfer restrictions will be imposed.[12]

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859 (1998) (holding that a not-for-profit charitable corporation running a hospital in Kansas was governed by Kansas' not-for-profit corporation law rather than trust law). According to one commentator, the drafters of the 1987 Model Act expressly intended to eliminate the application of the charitable trust doctrine to not-for-profit corporations formed for charitable purposes. L. Moody, "The Who, What, and How of the Revised Model Nonprofit Corporation Act," 16 N.Ky.L.Rev. 251 at 263-64 (1989) (citing minutes of the Committee on Nonprofit Corporations (Sept. 26, 1980)).

[11] See Baarslag v. Hawkins, 12 Wn. App. 756, 531 P.2d 1283 (1975).

[12] See, e.g., In re Multiple Sclerosis Serv. Org. of N.Y., Inc., 68 N.Y.2d 32, 39 n.5, 496 N.E.2d 861, 864 n.5, 505 N.Y.S.2d 841, 844 n.5 (1986) ("Assets legally required to be used for a particular purpose are those received pursuant to a will or other instrument limiting the purpose for which the assets may be used."). See also City of Fort Payne v. Fort Payne Athletic Ass'n, Inc., 567 So.2d 1260, 1264 (Ala. 1990) (affirming that the Alabama dissolution statute, which is identical to RCW 24.03.225(3), did not apply "because the deed conveying the property to [the not-for-profit corporation] did not contain conditions or limitations on the property's use." The court continued that "[a]lthough there are no cases interpreting this Code section, the trial judge's interpretation is a logical construction of the language employed in [such statute]."). Even in Texas, which has interpreted this language more broadly, it still must be shown that the assets were "received" by a charitable corporation with an intent, either express or
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In order to apply RCW 24.03.225(3), the attorney general must first establish that the assets of a not-for-profit corporation were "received and [are] held" for charitable purposes. To satisfy this burden, the attorney general must present facts that conclusively show (i) a donor's intent that the assets given to the corporation be used for express charitable purposes (or that they not be used for non-charitable purposes), and (ii) that the not-for-profit corporation holds these donated assets for charitable purposes. In other jurisdictions that have analyzed the "charitable" status of a Blue Cross/Blue Shield ("BCBS") licensee, the courts have focused on the factual record to determine whether such corporations were charitable or whether their assets should be impressed with a charitable trust.[13] In the Cantilo Deposition, Mr. Cantilo argued that such cases are very fact-specific and therefore distinguishable from the Premera case.[14] I believe that the much more important point is that any determination regarding the existence or non-

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implied, that the assets be used only for charitable purposes. Blocker v. State ("Blocker"), 718 S.W.2d 409, 415 (Tex. App.—Houston [1st Dist.] 1986).

[13] See, e.g., ABC for Health, Inc. v. Comm'r of Ins. ("ABC for Health"), 250 Wis.2d 56, 70-71, 640 N.W.2d 510, 515-16 (2001) (in the context of a BCBS conversion, the court held that "[t]he record conclusively shows that [the BCBS nonprofit corporation] has not operated exclusively for charitable purposes. [Since its formation, the BCBS entity] has provided health insurance to individuals who paid premiums. Although it operated as a nonprofit corporation, being a nonprofit, non-stock corporation is different from operating exclusively as a charitable entity. For example, [the BCBS nonprofit corporation] has not qualified [as a 501(c)(3) organization] because that section requires, among other things, that the organization be operated 'exclusively for religious, charitable…or educational purposes.' Additionally, there is nothing in the record which shows [the BCBS nonprofit corporation] was created or maintained through charitable gifts. It sold insurance to people who paid premiums to become policyholders. Therefore, we conclude that the Commissioner was correct in determining that neither the cy pres doctrine nor [the charitable trust statute] is an impediment to the plan of conversion."). See also, e.g., Abbott v. Blue Cross and Blue Shield of Tex., Inc. ("Abbott"), 113 S.W.3d 753, 766 (Tex. App.—Austin 2003) ("The evidence makes it clear that [the BCBS nonprofit corporation] acquired none of its assets from donors who intended their donation to contribute to the public benefit. In fact, there is no evidence that the corporation has ever received a donation or that one has ever been made. The evidence is undisputed that all of the assets maintained by [the nonprofit corporation] … were either originally obtained through transactions with a *quid pro quo* or were a result of the investment of the proceeds of those transaction. Not only has [the BCBS nonprofit corporation] never had a public charitable purpose, the evidence is undisputed that with only minor exceptions, all revenues generated by [the nonprofit corporation] have been used to benefit its policyholders or for its own corporate purposes."). Some other courts that have looked at BCBS conversions have based their rulings, not on an analysis of charitable purpose or charitable trust, but instead on the provisions of not-for-profit conversion statutes (see, e.g., Hawes v. Colo. Div. of Ins., 32 P.3d 571 (Ct. of App. 2001); and Consumers for Affordable Health Care, Inc. v. Superintendent of Ins., 809 A.2d 1233 (Me. 2002)) and unique provisions in such states' not-for-profit corporations law (see, e.g., Blue Cross and Blue Shield of Mo. Inc. v. Nixon, 81 S.W.3d 546 (Mo. Ct. App. 2002); and Blue Cross and Blue Shield of Kan. Inc. v. Stovall, 2000 WL 34001584 (Kan. Dist. Ct. 2000)). The Missouri and Kansas cases also provide support for the proposition that a not-for-profit BCBS corporation cannot automatically be presumed to be a charitable organization, and that its assets cannot be automatically impressed with a charitable trust.

[14] See Cantilo Deposition at 75-77, 88-92.

existence of a charitable trust in Washington as to a BCBS licensee must necessarily be based upon an analysis of the facts in each particular case. Even though C&B apparently recognizes the importance of the specific facts in making such determinations in other states, when it comes to analyzing the Proposed Conversion C&B insists on "assuming" that a charitable trust exists and avoiding the factual analysis necessary to support such a conclusion. This approach is not permissible under Washington law—one cannot simply assume or presume a charitable purpose or the existence of a charitable trust based on nothing more than general rhetoric about the history of other organizations in other jurisdictions.

c. *Summary*. Washington courts will not automatically infer that a not-for-profit corporation is a charitable corporation. Premera clearly is not a "public benefit nonprofit corporation" as defined by the Washington Legislature. Moreover, Washington courts will not lightly apply the charitable trust doctrine to the assets of a not-for-profit corporation. If a charitable trust were to be impressed on certain assets of a not-for-profit corporation, just as in the application of RCW 24.03.225(3), there must be a clear showing that the subject assets were "received" by the not-for-profit corporation subject to a restriction requiring them to be utilized for a particular charitable purpose. Absent such a specific factual showing, the corporation's assets cannot be subjected to either a charitable trust or to the "charitable trust"-like transfer limitations of the Washington not-for-profit corporations statute.

2. It appears that the Washington Legislature did not intend or believe that assets of a not-for-profit healthcare insurer should be subjected to a "charitable trust"-like protective process.

In 1996 and 1997, the attorneys general of several states became increasingly concerned about the conversion of not-for-profit healthcare corporations across the United States. Prior to that time, common law and not-for-profit corporation statutes provided state attorneys general limited authority to review conversion activities of these corporations. Through their national organization, the National Association of Attorneys General ("NAAG"), the participating attorneys general (which included the Washington Attorney General) developed a model conversion statute that was intended to clarify the role of attorneys general in protecting the assets of charitable not-for-profit corporations and to standardize the application of charitable trust provisions to healthcare nonprofits.[15] The drafting of the NAAG Model Act was

[15] According to NAAG, "under general common law principles Attorneys General have traditionally served as protectors of charitable assets on behalf of the beneficiaries of charitable health care entities…. The responsibility of the Attorney General's office [in healthcare conversions] is to conduct a thorough and complete review under the model act, to do so in a manner that is open to public comment and scrutiny, and to protect the charitable assets

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initiated in March 1997, based on, among other things, various conversion statutes previously approved by state legislatures, and was intended to regulate the conversion of hospitals, HMOs, and healthcare insurers, as well as not-for-profit organizations affiliated with these entities.[16] As of September 1997, 35 states had considered, and 19 had adopted, legislation governing not-for-profit healthcare conversions, mergers and acquisitions.[17]

In 1997, the Washington Legislature approved a not-for-profit conversion statute, currently set forth in RCW Ch. 70.45, based in large part on drafts of the NAAG Model Act. However, while the NAAG Model Act and several other jurisdictions' conversion statutes applied to both not-for-profit hospitals and healthcare insurers, the Washington Legislature expressly limited the applicability of Ch. 70.45 to not-for-profit hospitals only.[18] Ch. 70.45, which is similar to the NAAG Model Act except for its inapplicability to not-for-profit healthcare insurers, presumes that a not-for-profit hospital holds charitable assets and that those assets need to be protected by the attorney general.[19] By stopping short of including healthcare insurers in Ch. 70.45, Washington fell into line with the majority of states that adopted conversion statutes during the 1996-1997 period.[20] This decision by the Legislature not to include healthcare insurers

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involved consistent with the Attorney General's traditional trust duties." NAAG, Model Act for Nonprofit Healthcare Conversion Transactions (1998) ("NAAG Model Act"), cmt. at 1, 10.

16 NAAG Model Act, cmt. at 1 & Section 1.01.

17 K. Donohue, "Crossroads in Hospital Conversions—A Survey of Nonprofit Hospital Conversion Legislation," 8 Annals Health L. 39 at 63 (1999).

18 "The health of the people of our state is a most important public concern. The state has an interest in assuring the continued existence of accessible, affordable health care facilities that are responsive to the needs of the communities in which they exist. The state also has a responsibility to protect the public interest in nonprofit hospitals and to clarify the responsibilities of local public hospital district boards with respect to public hospital district assets by making certain that the charitable and public assets of those hospitals are managed prudently and safeguarded consistent with their mission under the laws governing nonprofit and municipal corporations." RCW Ch. 70.45 pmbl.

19 As stated in the Final Bill Report for RCW Ch. 70.45, the state may approve a conversion transaction only if it determines that "appropriate steps have been taken to safeguard charitable assets and to ensure that any proceeds of the transaction are used for appropriate charitable health and health care purposes." This statute was adopted because "[t]here is concern that should such acquisitions [of not-for-profit hospitals] occur in Washington, our laws are insufficient to ensure that these public interests will be served." Final B. Rep. SSB 5227, 55th Leg., 1997 Reg. Sess. (Wash. 1997).

20 P. Bisesi, "Conversion of Nonprofit Health Care Entitles to For-Profit Status," 26 Cap. U. L. Rev. 805 at 836 (1997) ("In 1997, 90 legislative bills [dealing with not-for-profit conversions] were introduced in 30 states….While
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in Washington's conversion statute seems to me quite logical, since hospital care has for many decades been considered inherently charitable under both common law and tax law. By contrast, as described in this Supplemental Report, serious questions existed and still exist as to the charitable nature of essentially commercial health insurance operations. Under established principles of statutory construction, the Washington Legislature's decision to exclude not-for-profit healthcare insurers from Ch. 70.45, in marked contrast to the broader sweep of the NAAG Model Act, gives rise to a presumption that the Legislature intended to reject the application of charitable trust restrictions to not-for-profit healthcare insurers in Washington.[21]

In May 2001, the Washington Legislature had yet another opportunity to impose charitable limitations upon not-for-profit healthcare insurers, when it adopted RCW Ch. 48.31C (the "Holding Company Act"), but again the Legislature declined to do so. Although somewhat similar to Ch. 70.45 in that the Holding Company Act provides the OIC an opportunity to approve conversion transactions, the standards of review, the OIC's authority, and the general approach of these two statutes are remarkably different. For example, one of the stated purposes of the Holding Company Act is to protect against *insolvencies* of healthcare contractors and health maintenance organizations;[22] by contrast, the stated purpose of Ch. 70.45 is to provide the state with the authority to safeguard the charitable and public assets of not-for-profit hospitals.[23] The basic approaches of the two statutes are also fundamentally different: Ch. 70.45 requires that the hospital show that the conversion transaction satisfies certain required elements, including fair value, due diligence and compliance with fiduciary duties;[24] by contrast, the Holding Company Act seems to presume that the transaction is legally proper and permissible unless the OIC satisfies the burden of showing that the transaction is not financially viable or that anti-trust issues exist.[25] In adopting the Holding Company Act, the Legislature had a clear second opportunity to apply charitable

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most of these laws only deal with nonprofit hospital conversions, a few are broad enough to encompass other nonprofit health care organizations, such as conversions of HMOs and Blue Cross and Blue Shield Plans.").

[21] See Lundberg, 115 Wn. App. at 177-78, 60 P.3d at 599 ("When the model act in an area of law contains a certain provision, but the Legislature fails to adopt such a provision, our courts conclude that the Legislature intended to reject the provision."). See also State v. Coria, 105 Wn. App. 51, 17 P.3d 1278 (2001).

[22] See House B. Rep. SHB 1792, Test., 57th Leg., 2001 Reg. Sess. (Wash. 2001).

[23] See supra note 18.

[24] RCW 70.45.070.

trust principles to not-for-profit healthcare insurers, but appears to have rejected this notion a second time.[26] Because the Legislature used language in the Holding Company Act that was significantly different from the language of Ch. 70.45, a logical inference under established principles of statutory construction is that the Legislature intended this different treatment of not-for-profit healthcare insurers.[27]

In the C&B Legal Opinions, C&B makes the argument that these differences between the Holding Company Act and Ch. 70.45 do not imply a different legislative intent. Citing the statutory construction principle of *in pari materia,*[28] C&B argues that, under this principle, the different standards of review under Ch. 70.45, including its fair value, due diligence and fiduciary duty requirements, can actually be imported into conversion proceedings under the Holding Company Act.[29] However, in Washington, the doctrine of *in pari materia* cannot be used to bridge such a wide gulf between two statutory regimes. As discussed above, Ch. 70.45 and the Holding Company Act have widely divergent stated purposes—Ch. 70.45 was designed to protect the charitable assets of not-for-profit hospitals, while the Holding Company Act was designed to protect against insolvencies of healthcare contractors and health maintenance

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[25] RCW 48.31C.050.

[26] While it is true that the Holding Company Act was also meant to apply to for-profit entities as well as not-for-profit entities, it is noteworthy that the legislative history recites the Legislature's belief that the statute was "designed to address the [not-for-profit] characteristics" of the many healthcare insurers that were organized as not-for-profits. See House B. Rep. SSB 5793, Test., 57th Leg., 2001 Reg. Sess. (Wash. 2001). Yet the statute does not include due diligence, fair value and other charitable trust-like provisions similar to those of Ch. 70.45.

[27] See Lundberg, 115 Wn. App. at 177, 60 P.3d at 598-99 (stating a "well established" canon of statutory interpretation: "[W]here the Legislature uses language in one instance but different language in another dealing with similar subjects, a difference in legislative intent is indicated.").

[28] "Statutes in pari materia are those which relate to the same person or thing, or the same class of persons or things; and in construing a statute, or statutes, all acts relating to the same subject matter or having the same purpose should be read in conjunction therewith as together constituting one law. The object of the rule is to ascertain and carry into effect the intent of the legislature, and it proceeds upon the supposition that the several statutes having to do with related subject matters were governed by one spirit or policy, and were intended to be consistent and harmonious in their several parts and provisions." State v. Houck, 32 Wn.2d 681, 684-85, 203 P.2d 693, 695-96 (1949). See also Hallauer v. Spectrum Props., Inc. ("Hallauer"), 143 Wn.2d 126, 146, 18 P.3d 540, 550 (2001) (citing State v. Wright, 84 Wn.2d 645, 650, 529 P.2d 453, 457 (1974)).

[29] See February 2004 C&B Legal Opinion, Exhibit A at 7 (stating that because both statutes "concern nonprofit health care conversions and relate to the impact that such conversions will have on the public," the doctrine of *in pari materia* may be applicable as "an important public policy of Washington."). See also C&B Supplemental Report at 43-44.

organizations.[30] The two statutes also have very different subject matters—Ch. 70.45 applies only to not-for-profit hospitals, while the Holding Company Act applies to both for-profit and not-for-profit healthcare insurers. As previously discussed, the basic approaches and evidentiary burdens of Ch. 70.45 and the Holding Company Act are also irreconcilably different—under Ch. 70.45, the converting hospital has the burden of showing that certain substantive and procedural requirements have been met, whereas under the Holding Company Act the transaction is presumed proper unless the OIC satisfies the burden of showing that there are financial viability or anti-trust problems.[31] In my view, the purposes and approach of these two statutes are so widely divergent as to be irreconcilable, and C&B's reference to the fact that they both deal with healthcare entities is not a sufficient basis for applying Washington's *in pari materia* doctrine. Rather than construing the Holding Company Act to include proof requirements like those of Ch. 70.45, I conclude that the Washington Legislature must be presumed to have rejected the application of such requirements—and of charitable trust principles—in proceedings under the Holding Company Act, including the current proceeding relative to the Proposed Conversion.

3. It is highly doubtful that the assets of Premera should be impressed with a charitable trust.

a. *No Showing of a Narrow Charitable Purpose.* Everything that I have reviewed leads me to believe that Premera is primarily a commercial enterprise that would be difficult to classify as a charitable organization under the Washington legal principles described above. As noted earlier, neither PREMERA nor Premera BC is or ever has been eligible for tax exempt status under Sec. 501(c)(3); thus, they are not "public benefit nonprofit corporations" under Washington law, and may not hold themselves out "as operating to benefit the public." Even more importantly, Premera provides services only to those individuals with whom it has a contractual relationship, and virtually all assets received by Premera are cash payments for services rendered, which can hardly be said to have been given by customers with any donative or restrictive intent. The source of Premera's revenues (and thus its accumulated assets) is identical to that of a for-profit commercial healthcare insurer. In 1985, the U.S. Congress recognized that there was essentially no difference between not-for-profit and for-profit commercial corporations that provide healthcare insurance, characterizing the so-called social welfare organizations (such as BCBS licensees) that provide healthcare insurance as "so inherently commercial" that their tax-exempt status

[30] See discussion supra notes 22-23.

[31] See discussion supra notes 24-25.

should be revoked.[32] Against this factual backdrop, it seems highly doubtful that the Washington Attorney General could succeed in satisfying the burden of showing that Premera's assets are the subject of a charitable trust. Indeed, the only reported judicial decisions of which I am aware in which courts in other states have conducted a factual inquiry into the "charitable" status of BCBS licensees have concluded that the BCBS affiliates were *not* charities and that their assets were *not* subject to charitable trust restrictions.[33] This may explain why neither the OIC Consultants, the Attorney General, nor any of the intervenors in this proceeding has made any attempt to make such a factual showing as to Premera's "charitable" status, and why C&B finds it more convenient to "assume" the issue away—because it seems highly likely that such a factual inquiry would fail to establish a charitable trust, which would in turn upset the entire "house of cards" fabricated by the OIC Consultants (including all of their arguments as to safeguarding public assets, ensuring the transfer of full value, etc.).

b. *Prior Federal Tax Exemption Not Conclusive of Charitable Nature*. The OIC Consultants have also argued that Premera is charitable by nature, or at least that its assets should be impressed with a charitable trust, because Premera BC operated prior to 1986 pursuant to a federal income tax exemption.[34] However, this argument is faulty in that Premera BC's tax exemption was not pursuant to Sec. 501(c)(3), the exemption available to not-for-profit entities that operate exclusively for religious, charitable, or scientific purposes (among others). Instead, Premera BC operated under Sec. 501(c)(4), an exemption

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[32] H.R. Rep. No. 426, 99th Cong., 1st Sess. at 664 (1985). See also 26 U.S.C. 501(m).

[33] See ABC for Health, 250 Wis.2d at 70-71, 640 N.W.2d at 515-16 (the court held that "[t]he record conclusively shows that [the BCBS nonprofit corporation] has not operated exclusively for charitable purposes. [Since its formation, the BCBS entity] has provided health insurance to individuals who paid premiums. Although it operated as a nonprofit corporation, being a nonprofit, non-stock corporation is different from operating exclusively as a charitable entity. For example, [the BCBS nonprofit corporation] has not qualified [as a 501(c)(3) organization] because that section requires, among other things, that the organization be operated 'exclusively for religious, charitable…or educational purposes.' Additionally, there is nothing in the record which shows [the BCBS nonprofit corporation] was created or maintained through charitable gifts. It sold insurance to people who paid premiums to become policyholders. Therefore, we conclude that the Commissioner was correct in determining that neither the cy pres doctrine nor [the charitable trust statute] is an impediment to the plan of conversion."). See also Abbott, 113 S.W.3d at 766 ("The evidence makes it clear that [the BCBS nonprofit corporation] acquired none of its assets from donors who intended their donation to contribute to the public benefit. In fact, there is no evidence that the corporation has ever received a donation or that one has ever been made. The evidence is undisputed that all of the assets maintained by [the nonprofit corporation] … were either originally obtained through transactions with a *quid pro quo* or were a result of the investment of the proceeds of those transactions. Not only has [the BCBS nonprofit corporation] never had a public charitable purpose, the evidence is undisputed that with only minor exceptions, all revenues generated by [the nonprofit corporation] have been used to benefit its policyholders or for its own corporate purposes.").

applicable to not-for-profit entities operating for the "promotion of social welfare" rather than for charitable purposes. Unlike charitable organizations exempted under Sec. 501(c)(3), Sec. 501(c)(4) organizations are not prohibited from distributing their assets to members or individual shareholders, a characteristic obviously inconsistent with true charitable status.[35] Moreover, as discussed above, in 1985 Congress concluded that the tax exemption given to BCBS healthcare insurers, including Premera BC, had been improper because such entities were essentially commercial organizations.

There is also one other flaw in the argument that a charitable trust should be deemed to flow from Premera BC's past tax-exempt status. Just because Congress or some other governmental entity believes that there are public policy reasons to provide tax incentives to certain businesses (e.g., to encourage increased employment, which expands the tax base and keeps workers off unemployment and welfare rolls) does not and should not automatically mean that those businesses are charities or that their assets should be impressed with a charitable trust. If that were the case, Boeing, Microsoft and a large percentage of the Washington corporations engaged in the technology industry, among others, would have to be considered charities or charitable trusts under Washington law, due to their receipt of research and development tax credits, business and occupation tax breaks and other tax incentives and credits. The lack of logic in this argument is self-evident.

4. Even if some portion of Premera's assets were considered subject to charitable limitations, the structure of the Proposed Conversion appears to satisfy the transfer requirements of RCW 24.03.225(3).

As discussed above, I believe that the vast majority of Premera's assets were received as payments for services rendered as part of Premera's commercial operations, and not as the result of any charitable activities. While I do not know whether Premera may historically have acquired any of its assets subject to a specific limitation that they must be utilized for charitable purposes, I would be highly skeptical that even a majority of Premera's current assets are subject to such explicit limitations. I believe that most, if not all, of Premera's existing assets have been accumulated through the reinvestment of payments from commercial customers into Premera's business, and I doubt that any of these commercial payments could

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[34] PREMERA was incorporated in 1994. Thus, it never had the benefit of a federal tax exemption.

[35] See, e.g., Abbott, 113 S.W.3d at 764 ("[W]here the law allows a nonprofit corporation to be operated solely for the benefit of its members, the corporation cannot be deemed as a matter of law to be a public charity.").

be shown to have been given to Premera with a donative intent, much less subject to a restriction that the funds be used exclusively for charitable purposes. Thus, in my view, the overwhelming majority of Premera's assets cannot be subjected to a charitable trust under Washington law.

It is possible, of course, that someone might be able to make a clear showing that some of Premera's existing assets were actually received by Premera subject to explicit limitations permitting their use only for charitable purposes.[36] If such a showing were made, the key issue would then become whether the manner in which those assets are dealt with under the Proposed Conversion satisfies the requirements of RCW 24.03.225(3). In this connection, I agree with the characterization of the Washington Attorney General to the effect that the proper metric is whether there are as many assets "available" for application to charitable purposes after the Proposed Conversion as there were before.[37] At present, it is difficult to discern any significant portion of Premera's assets that is truly "available" for charitable applications—virtually all of Premera's assets are currently utilized in the conduct of an inherently commercial business. After the Proposed Conversion, by contrast, there will be an "unlocking" of enormous value that will gradually become available to the two Foundation Shareholders. Since the stated purposes of the Foundation Shareholders[38] do appear to be "substantially similar" to the purposes that would have governed any of Premera's assets that were potentially charitable, it appears to me that the requirements of RCW 24.03.225(3) will be satisfied. In fact, it is difficult for me to understand how anyone could believe or even argue that more assets would be available for charitable uses if the Proposed Conversion were not approved.

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[36] It is worth noting that the receipt of some assets that are subject to such explicit charitable limitations does not render the entire corporation, or all of the corporation's other assets, charitable. See, e.g., Health Midwest, 2003 WL 328845 at 26 ("The cy pres statute [that governs changes to the purposes of charitable trusts] applies only to any restricted gifts and not the entity as a whole. No restricted gifts have been identified herein and therefore the cy pres statute does not apply."). This conclusion is also evident in the structure of RCW 24.03.225, which would not specify different disposition rules for charitable vs. non-charitable assets if the mere possession of the former caused all of the latter to be classified as charitable assets.

[37] See Mem. to Christine O. Gregoire, Att'y Gen. of Wash., from David Walsh, Deputy Att'y Gen., Rusty Fallis, Assistant Att'y Gen., and Christina Gerstung Beusch, Assistant Att'y Gen., dated October 15, 2002, at 3.

[38] See Article III, Section 1 of the proposed drafts of the Articles of Incorporation for each of the Foundation Shareholders set forth in the Amended Form A Filing.

5. Because there has been no showing that Premera's assets should be impressed with a charitable trust, many of the OIC Consultants' arguments in their supplemental reports lack any legal foundation.

a. *Debate Over Precise Terms of Proposed Conversion*. Based on my conclusion that the overwhelming majority (if not all) of Premera's assets cannot be subjected to a charitable trust under Washington law, I consider most of the debate among the various OIC Consultants over the precise terms under which the Foundation Shareholders will be able to vote and monetize their shareholdings in New PREMERA to be superfluous. The asserted basis for criticizing these terms is that, "assuming" all of Premera's assets are subject to a charitable trust, the number of dollars that ultimately make their way to the Foundation Shareholders arguably must be maximized to the ultimate degree. However, since in my view only a small portion of Premera's assets (if any) could conceivably be shown to be subject to a charitable trust, and since the value that Premera has voluntarily proposed to be transferred to the Foundation Shareholders will (even under worst-case assumptions) be far greater than the amount of assets currently available for charitable uses, it seems to me that all of this debate is unnecessary and misplaced, because neither Washington charitable trust principles nor RCW 24.03.225(3) requires a voluntary donor to maximize the amounts that it sets aside for charitable purposes.

b. *Allocation of Premera Assets between Washington and Alaska*. Based on the same reasoning, the debate between insurance regulators in Washington and Alaska as to the division of proceeds between the respective Foundation Shareholders of those two states also seems to be premised on the fallacious "assumption" that charitable trust principles are applicable, and seems to miss the more important point that, after the Proposed Conversion, both states will have far more assets available for charitable applications than they will have if the Proposed Conversion is not approved.

c. *Payment of Trust and Escrow Fees.* In the C&B Supplemental Report, C&B argues that all fees of the trustee under the proposed Voting Trust and Divesture Agreement between New PREMERA and each of the Foundation Shareholders (filed with the OIC as part of the Amended Form A Filing, together, the "Voting Trust Agreement")[39] should be paid by New PREMERA rather than by the

[39] Washington law specifically recognizes voting trusts. The requirements for an effective voting trust under Washington corporate law are set forth in RCW Section 23B.07.300 ("One or more shareholders may create a voting trust, conferring on a trustee the right to vote or otherwise act for them, by signing an agreement setting out the provisions of the trust, which may include anything consistent with its purpose, and transferring their shares to the trustee…. A voting trust becomes effective on the date the first shares subject to the trust are registered in the
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respective Foundation Shareholders, because Premera is imposing on the Foundation Shareholders "unnecessary conditions."[40] This argument is premised directly on C&B's assumption that the Foundation Shareholders' assets are impressed with a charitable trust, must therefore be protected for public use and cannot be used to pay such expenses. However, since there has been no showing (and in fact I doubt that it could be shown) that Premera is a charitable organization or that its assets are subject to a charitable trust, this argument is based upon a faulty premise. Because it is highly doubtful there is any charitable trust here, the transfer of assets to the Foundation Shareholders in the Proposed Conversion will be a purely voluntary act of Premera, not required by either the Holding Company Act or Washington corporate or trust law. As a voluntary donor, Premera is entitled under Washington law to impose whatever requirements it desires as to the use of the donated assets.[41] It is typical, for example, for settlors of inter vivos and testamentary trusts to impose a requirement that the trustees' fees be paid from trust assets. This normal rule is not altered by the fact that Premera intends to establish the Foundation Shareholders as charitable trusts. Payment of a charitable trust's own operating expenses is considered to be within the trust's charitable purposes.

d. *Unallocated Shares Escrow*. If, by the time the OIC makes a determination as to the Proposed Conversion, Washington and Alaska have not mutually agreed to an allocation of Premera's assets between the respective Foundation Shareholders of those states, shares of New PREMERA equal to the number of shares that remain in dispute will be placed in an escrow account pending the resolution of the allocation dispute between the states.[42] In the C&B Supplemental Report, C&B argues that the

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trustee's name. A voting trust is valid for not more than ten years after its effective date unless extended under subsection (3) of this section." RCW 23B.07.300(1) and (2). "[A voting trust is] a reasonable voting device to accomplish legitimate objectives…. [RCW 23B.07.300] provides a simple and direct procedure for the creation of an enforceable voting trust." RCW 23B.07.300, cmt.). Based on my review of this statute and the proposed documents, I believe that the Voting Trust Agreement is effective to create a binding voting trust under Washington law.

[40] C&B Supplemental Report, summ. at 21.

[41] See, e.g., McNevin v. Solvay Process Co., 53 N.Y.S. 98, 99 (N.Y. App. Div. 1898) ("It must be conceded at the outset that a person or a corporation proposing to give a sum for the benefit of any person or any set of persons has the right to fix the terms of his bounty, and provide under what circumstances the gift shall become vested and absolute.").

[42] See Section 2 of the Unallocated Shares Escrow Agent Agreement filed with the OIC as part of the Amended Form A Filing (the "Unallocated Shares Agreement").

application of such an escrow "suffers from a number of serious infirmities"[43] and that the Unallocated Shares Escrow is one of the documents that "undermines" the transfer of the "fair value" of Premera's assets to the Foundation Shareholders.[44] However, this argument is likewise based on a faulty premise, since there has been no showing (and in fact I doubt that it could be shown) that Premera is a charitable organization or that its assets are subject to a charitable trust. Absent charitable trust restrictions, a donor (such as Premera, here) is entitled to choose the timing of its intended gift; and the donee or donees of the gift, while entitled to refuse to accept it altogether, have no legal right to bargain with the donor or insist on different timing or terms.[45] The proposed share escrow represents a reasonable and customary mechanism for dealing with distribution of assets pending later resolution of a dispute. To deny Premera the right to employ such a mechanism in order to achieve the timing that it (the donor) desires would in effect give the donees (the Foundation Shareholders) a veto over the timing of the gift—a veto which they are not legally entitled to assert. Nor does it seem to be in the public interest to allow for further delays in the process of taking New PREMERA public, which as noted above will be the event that "unlocks" and makes available substantial value for charitable applications in the two states.

e. *Shares Outside of Voting Trust.* In the event that the Blue Cross Blue Shield Association (the "BCBSA") does not approve of the Foundation Shareholders each holding 5% of New PREMERA shares outside their respective voting trusts, and the states of Washington and Alaska are unable to agree as to their respective allocations of the 5% of New PREMERA shares that is to be collectively held by the Foundation Shareholders outside of the voting trusts, the Voting Trust Agreement provides that the full 5% will be allocated to the Washington Foundation Shareholder. In the Blackstone Report, Blackstone argues that this provision should be eliminated and that each Foundation Shareholder should be able to hold 5% of the New PREMERA shares outside of the trust. Because this is a requirement of the BCBSA, whose decision is not within the control of Premera, I believe that such a default provision is a necessary and reasonable safeguard to ensure that if such approval is not granted, neither of the states is given practical means for delaying (or even preventing) the consummation of Premera's voluntary gift to the Foundation Shareholders, and the completion of the New PREMERA public offering for the benefit of the citizens of both states. It is noteworthy that the inclusion of this default provision does not obligate

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[43] C&B Supplemental Report at 77.

[44] C&B Supplemental Report at 89.

[45] See, e.g., supra note 41.

the Foundation Shareholders to any particular allocation; they still have the ability to negotiate a different allocation, just not an ability to delay the Proposed Conversion while they negotiate.

f. *Restrictions on Foundation Shareholders' Purposes and Activities*. In the C&B Supplemental Report, C&B argues that the required purposes and restrictions placed upon the Foundation Shareholders' respective activities as set forth in their Articles of Incorporation,[46] in Sections 1.02 and 1.03 of the Transfer, Grant and Loan Agreement filed with the OIC as part of the Amended Form A Filing (the "Transfer Agreement"),[47] and in the Plan of Distribution filed with the OIC as part of the Amended Form A Filing (the "Plan of Distribution")[48] are unreasonable, too restrictive and not in the "public interest."[49] However, as noted earlier, a clear expression of the donor's restrictive intent is essential to create a charitable trust under Washington law, and these restrictions are certainly consistent with the creation of a charitable trust under Washington law.[50] Perhaps more to the point, Premera, as a

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[46] The purposes of the Foundation Shareholders under each of their proposed Articles of Incorporation are set forth in Article III thereof. Under such Article, the Foundation Shareholders are deemed to be organized exclusively for the promotion of social welfare and charitable purposes under Sec. 501(c)(4) and shall promote the health of the residents of their respective states by, among other things, generally improving the quality of healthcare and related services, meeting unmet healthcare needs, educating healthcare providers, and supporting research and other programs related to healthcare. Under Article IV of the Articles of Incorporation for each of the Foundation Shareholders, by contrast, the Foundation Shareholders may not, among other things, engage in activities that are prohibited pursuant to Sec. 501(c)(4), engage in certain political activities, distribute any net earnings to private individuals, or engage in certain lobbying efforts. Any changes to these provisions, as well as any other article under the Articles of Incorporation for each of the Foundation Shareholders (other than Article XI thereof), must be approved by the Attorney General of the applicable state. See proposed Articles of Incorporation for the Foundation Shareholders, Article X.

[47] Section 1.02 of the Transfer Agreement restates the purposes of each of the Foundation Shareholders as set forth in their respective Articles of Incorporation. Section 1.03 provides substantially the same limitations set forth in Article IV of each Foundation Shareholders' Articles of Incorporation.

[48] Section 2 of the Plan of Distribution provides substantially the same purposes and limitations for the Foundation Shareholders as set forth in Sections 1.02 and 1.03 of the Transfer Agreement.

[49] C&B Supplemental Report at 25-27, 30, 34, 86.

[50] There is a striking contrast between Premera's unequivocal creation of charitable trust restrictions as to the Foundation Shareholders, and the extremely dubious argument by the OIC Consultants that Premera itself is subject to a charitable trust. Each of the Foundation Shareholder's purposes are explicitly limited to a distinctly charitable purpose, promoting the health of the residents of their respective states. Moreover, each of the Foundation Shareholders will receive assets subject to explicit charitable use restrictions; by contrast, there has been no showing (and I doubt that it could be shown) that Premera received any significant portion of its assets subject to explicit charitable use restrictions. Lastly, by granting the Washington Attorney General the power to approve or disapprove of any activity of the Foundation Shareholders that is outside the stated charitable purposes, Premera has provided authority to the Attorney General similar to that found in RCW 24.03.225(3). Because of these characteristics, there
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voluntary donor of assets, has the legal right and authority to limit the use of those assets in whatever manner it chooses, including by the imposition of charitable trust or other protective restrictions in whatever degree of detail it desires. As noted earlier, the recipients of the donated assets have no right to dictate or negotiate over the terms of the gift.[51] It is more than a little ironic that C&B, having asserted repeatedly that Premera's assets are subject to charitable restrictions, would contradict its own position by arguing that the transfers to the Foundation Shareholders need not be subjected to continuing charitable restrictions.

g. *Transfers to Foundation Shareholders Are Not Breaches of Fiduciary Duty*. In the C&B Supplemental Report, C&B makes the argument that Premera must be a charitable corporation, because otherwise its transfer of assets to the Foundation Shareholders in the Proposed Conversion would have to "be considered a breach of the [Premera] board's and management's fiduciary duty to the owners of the company."[52] C&B continues that the conveyance of "hundreds of millions of dollars where there is no legal requisite to do so…cannot be deemed anything but a breach of fiduciary duty."[53] This legal conclusion, and the inference of "charitable" status that C&B attempts to support with it, is utterly without merit under Washington corporate law.

As I have previously stated, there has been no showing of facts that would support the conclusion that Premera is a charitable corporation, that its assets should be impressed with a charitable trust or that any of its assets were "received and [are] held" for charitable purposes. Without such a showing, upon dissolution of Premera pursuant to the Proposed Conversion, RCW 24.03.225(3) is simply inapplicable, and Premera's distribution of its assets is instead governed by RCW 24.03.225(4) and (5), which prescribe that assets be distributed "in accordance with the provisions of the articles of incorporation or

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should be no basis for arguing that Premera has not created a charitable trust with respect to the assets of the Foundation Shareholders. Conversely, because these characteristics have not been shown to be present with respect to the assets of Premera, I conclude that Premera and its assets are not subject to a charitable trust.

[51] See, e.g., supra note 41

[52] C&B Supplemental Report at 50.

[53] Id. C&B quite properly refrains from labeling the proposed transfer of assets to the Foundation Shareholders a "corporate waste." The "waste" concept is inherently inapplicable to the final distributions made by a corporation as a result of dissolution—by their very nature, such distributions (to shareholders or, as here, to beneficiaries described in a not-for-profit corporation's Articles of Incorporation) are always transfers for no consideration, since their purpose is to eliminate any remaining assets from the dissolved corporation.

the bylaws to the extent that the articles of incorporation or bylaws determine the distributive rights of members, or any class or classes of members, or provide for distribution to others," and that "[a]ny remaining assets may be distributed to such persons, societies, organizations or domestic or foreign corporations, whether for profit or not for profit, as may be specified in a plan of distribution…."[54]

Premera BC's Articles of Incorporation state that upon dissolution, all of the proceeds from its assets must be distributed to PREMERA.[55] PREMERA's Articles of Incorporation, in turn, specifically state that upon winding up and dissolution, its assets shall be distributed to "one or more nonprofit corporations or other nonprofit entities to be used exclusively for purposes consistent with the purposes" of PREMERA.[56] C&B does not appear to be arguing that PREMERA's proposed transfer of assets to the Foundation Shareholders is not "consistent with" its purposes (to the contrary, C&B argues that such a transfer is required). In this regard, I agree with C&B's apparent conclusion that the uses that will be made of the transferred assets by the Foundation Shareholders will be "consistent with" PREMERA's purposes.[57] Since I conclude that the proposed asset transfers are in compliance with PREMERA's Articles of Incorporation, I see no legal basis for C&B's argument that Premera's directors would be breaching their fiduciary duty *by complying with* the requirement stated in such Articles of Incorporation as to transfers upon dissolution. Not only is C&B's argument on this point insupportable under Washington law; even if it were valid, it would provide no basis for concluding that Premera's assets must be subject to charitable restrictions. C&B does not cite, and I would venture to state that there does not exist, any judicial authority for this breathtaking logical leap, namely that if there is a fiduciary limitation against the contribution of assets to a charity, then such assets must have been subject to charitable restrictions in the first place. The lack of logic in this argument is self-evident.

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[54] RCW 24.03.225(4) and (5).

[55] Premera BC Articles of Incorporation, Article VIII.

[56] PREMERA Articles of Incorporation, Article XII. The purposes of PREMERA include managing, coordinating, supporting and promoting the activities of all not-for-profit entities of which it is the sole voting shareholder or in any other capacity the owner offering BCBS licensed plans.

[57] I interpret the requirement of PREMERA's Articles of Incorporation that the assets be used "for purposes consistent with" PREMERA's purposes to be a more relaxed standard than the "substantially similar" test found in RCW 24.03.225(3), which I also believe would be satisfied if it were shown that any of PREMERA's assets were subject to charitable trust restrictions.

Analysis of Provisions in the Amended Transaction Documents

The OIC Consultants have concluded in their supplemental reports that certain aspects of the structure and terms of the Proposed Conversion, and specifically the relationship and obligations between New PREMERA and the Foundation Shareholders as set forth in the transaction documents filed with the Amended Form A Filing, are unreasonable and inappropriate. In my view, the overall structure of the arrangements between New PREMERA and the Foundation Shareholders—including those reflected in the Voting Trust Agreement, the Registration Rights Agreement and the Transfer Agreement—is fairly commonplace in similar transactions (such as spin-offs and initial public offerings), entirely without regard to any requirements or restrictions that might arise under BCBSA licensing rules. The revised transaction documents set forth in the Amended Form A Filing contain a number of arrangements that are typical in these types of transactions.

a. *Termination of Voting Trust Agreement*. In the Blackstone Report, Blackstone argues that the term of the Voting Trust Agreement should expire upon any loss by New PREMERA of its right to use BCBS trademarks.[58] Blackstone suggests that the Voting Trust Agreement should terminate under such circumstances so that the Foundation Shareholders can freely sell their shares of New PREMERA stock on the open market, as if the BCBS divestiture requirements were the only reason for imposing the Voting Trust Agreement on the Foundation Shareholders. However, I believe that the continued existence of the Voting Trust Agreement during its full stated term is also important for the success of New PREMERA's initial public offering and subsequent market stability. For example, the Proposed Conversion is similar to fairly commonplace type of transaction where a division of an existing company is to be spun-off and taken public. In a spin-off, the original parent company usually will own a large percentage of the spun-off company even after the initial public offering. Since public investors may be distrustful of the parent corporation's ability to dominate the public company's board of directors in a way that serves the interests of the parent, or may be nervous about the potential effects of the parent's large "overhang" of potential selling activity on the public market price of the stock, the underwriters who conduct the public offering commonly seek to comfort investors by imposing limitations and obligations on the parent that address these concerns. In such circumstances, the underwriters seek to impose restrictions that limit the parent's ability to dominate voting contrary to the interests of public shareholders, and to obligate the parent to reduce its percentage holdings of the public company's stock

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[58] Blackstone Report at 9, 16.

according to a visible and predictable schedule. These restrictions, which are present in the Voting Trust Agreement, help reduce public investors' fears of unexpected selling pressure and price fluctuations and generally benefit both the Foundation Shareholders and the investing public from a financial perspective.

b. *Trigger for Change of Control Proposal*. Under the proposed Voting Trust Agreement, the Foundation Shareholders will be free to vote their own holdings of New PREMERA shares as to a "Change of Control Proposal," which is generally defined as a proposed issuance or transfer of more than 50.1% of New PREMERA's voting securities or business in a merger, consolidation or other transaction. In the Blackstone Report, as well as in the C&B Report, the OIC Consultants argue that a "Change of Control Proposal" under the terms of the Voting Trust Agreement should be triggered upon any transaction, including a stock issuance or a merger, in which the shareholders of New PREMERA prior to the transaction own less than 80% of the surviving corporation after the transaction.[59] Such a reduction to a 20% change of control threshold would, according to the OIC Consultants, allow the Foundation Shareholders to "voice their concern[s]" and vote on material transactions that have a "significant impact on the value of [their] ownership stake in [New PREMERA]."[60] Blackstone argues that this makes sense because such a definition would be consistent with the "change of control" definition under the New York Stock Exchange ("NYSE") rules.[61] I believe that this suggested change in the definition is both unnecessary and problematic. NYSE rules require a shareholder vote in the event that a listed company proposes a transaction in which 20% of its outstanding equity would be issued,[62] in order to ensure that minority shareholders have a "voice" in certain dilutive transactions. What neither Blackstone or C&B seems to recognize, however, is that, after the completion of New PREMERA's initial public offering, the corporation's shares will in all likelihood be listed on either NYSE or the National Market System of the Nasdaq Stock Market ("Nasdaq"), which has a similar rule.[63] Thus, a "change of control" vote will be

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[59] C&B Supplemental Report at 73; Blackstone Report at 17.

[60] Id.

[61] Blackstone Report at 8.

[62] NYSE Listed Company Manual, Section 312.

[63] See Rule 4350(i)(1)(B) of the Nasdaq Marketplace Rules, which requires shareholder approval when an issuance or potential issuance by an issuer will result in a "change of control" of the issuer. Pursuant to proposed Nasdaq Rule SR-NASD-2003-61 (filed with the Securities and Exchange Commission on March 23, 2003), a "change of control" will generally result if an investor obtains 20% or more of the common stock or voting power of an issuer on a post-transaction basis, subject to certain exceptions. This proposed rule has not yet been approved or effected.

required in the event of a proposed transaction resulting in a change of 20% ownership or voting of New PREMERA shares (subject to certain exclusions under those rules[64]); and, under the Voting Trust Agreement, the voting of the Foundation Shareholders' shares on that proposal will be controlled by the independent directors of New PREMERA, who will certainly view it as their responsibility to vote those shares with a view to the best interests of New PREMERA's minority shareholders. I believe this is adequate protection of the interests of the Foundation Shareholders in such circumstances. Allowing the Foundation Shareholders themselves to vote the shares in the event of a 20% "change of control" transaction certainly seems unnecessary from a corporate law standpoint—under Washington corporate law, I do not believe that a change of 20% ownership would be viewed as a change of control sufficient to impose higher duties of care on board members,[65] so it is difficult to see why shareholders should be given special voting powers in such situations.

Even assuming the desirability of affording special protection for the interests of the Foundation Shareholders in such circumstances, perhaps the most important point here is to recognize that such protection *has already been afforded* by the issuance of the Class B Common Stock to the Washington Foundation Shareholder. Under the terms of the Class B Common Stock share, the Washington Foundation Shareholder is entitled, in effect, to veto a broad variety of transactions, including issuances of stock that "would adversely affect the financial interests" of the Foundation Shareholders.[66] This veto right provides protection superior even to that of the NYSE/Nasdaq rules, although (like the NYSE/Nasdaq rules) it is subject to a variety of exceptions designed to allow New PREMERA to conduct various ordinary-course transactions that the public markets will expect it to be able to conduct without shareholder approval.[67] The suggested reduction of the "Change of Control Proposal" percentage to only

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[64] For example, proposed Nasdaq Rule SR-NASD-2003-61 provides that a "change of control" will not occur if (i) another shareholder or group of shareholders holds a greater interest in the issuer than that of the acquiring investor or (ii) issuer's management and directors as a group hold a greater interest in the issuer than that of the acquiring investor.

[65] Note that "Revlon" fiduciary duties, discussed infra at note 99 and accompanying text, would not be generally triggered unless the transaction resulted in a much larger change of ownership.

[66] See proposed New PREMERA Articles of Incorporation, Article II, Section (2)(d)(2).

[67] Pursuant to the proposed New PREMERA Articles of Incorporation, Article II, Section (2)(d)(2), the holder of the Series B Common Stock share is not entitled to vote as a separate voting group in the event of, among other things, (i) the issuance of capital stock in connection with a merger or acquisition approved by the Independent Board Majority or which constitutes an Approved Change of Control Proposal (each as defined therein), (ii) the issuance of
(footnote continued on next page)

20% would be in large part duplicative of the protections afforded by the Class B Common Stock veto, but it would circumvent the safeguards inherent in the ordinary-course exceptions to that veto, which I believe would be viewed negatively by potential investors in New PREMERA's initial public offering.

c. *Loss of Board Seat*. The proposed New PREMERA Articles of Incorporation, as filed in the Amended Form A Filing, provide that the Foundation Shareholders will lose their right to jointly nominate one member of the board of directors of New PREMERA upon the earliest to occur of (i) their respective ownership of New PREMERA capital stock dropping below 5% of the issued and outstanding capital stock of New PREMERA, or (ii) five years from the date of the Voting Trust Agreement. Blackstone argues in the Blackstone Report that the latter five year period is unacceptable and should be extended.[68] I believe that such a change would be atypical and inappropriate. In my experience, it is typical in a wide variety of financing, acquisition and other transactional documents for a large shareholder's negotiated right to a guaranteed board seat to disappear when the shareholder's ownership is reduced to the 10% range, and sometimes this occurs closer to the 20% ownership level. In my experience, it would be extremely unusual for a board seat to continue to be guaranteed all the way down to the 5% ownership level, since at that level a shareholder would not hold sufficient voting power to get its director elected even under a cumulative voting format. Under the divestiture schedule set forth in the Voting Trust Agreement, the highest percentage ownership that either of the Foundation Shareholders will hold by the fifth anniversary of the date of the Voting Trust Agreement is likely to be somewhere in the very low teens, and I believe this would be a typical point at which a guaranteed board seat would be lost.

d. *Definition of "Independence" for New PREMERA Directors*. In the Blackstone Report, Blackstone argues that the 2% of revenue test set forth in the definition of "independence" for New PREMERA's board of directors[69] needs to be adjusted because the current provision would allow a potentially "significant contributor" to New PREMERA's earnings to be an "independent" member of the

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capital stock pursuant to an underwritten public offering at or above market price, and (iii) the issuance of preferred stock in a public or private transaction after the fifth anniversary of the New PREMERA initial public offering.

[68] Blackstone Report at 9, 19.

[69] See proposed New PREMERA Bylaws, Article II, Section 4(f).

board.[70] This portion of the definition of "independent director" in the proposed Bylaws of New PREMERA is the same as the definition in the NYSE's rules.[71] In creating this definition, the NYSE concluded that the 2% of revenues/$1 million in revenues independence test is the most appropriate measure for determining whether directors have a "material relationship" with a listed company.[72] This standard was developed by the NYSE's corporate governance experts (subject to oversight and approval by the U.S. Securities & Exchange Commission), with reference to most of the major corporations in the U.S., many of which are substantially larger than Premera. I find it hard to conclude that the alternative proposed by Blackstone should be substituted for that of the NYSE in this regard. Additionally, if Blackstone's suggested language regarding the definition of an "independent director" was adopted, this would further narrow the pool of qualified potential directors with knowledge about healthcare issues who are eligible to serve as independent directors of New PREMERA, including specifically physicians.

e. *Functions of the Foundation Shareholders' Committees.* The Foundation Shareholders' respective proposed Bylaws set forth very specific functions for their respective Investment and Program Committees. In the C&B Supplemental Report, C&B suggests that such specificity raises "several serous concerns."[73] Although I tend to agree that such specificity would be unusual for most privately held for-profit corporations, I believe that these requirements are very appropriate for the Foundation Shareholders.

Good corporate governance dictates that boards of directors should be composed of individuals who in the aggregate possess all the skills necessary to effectively oversee corporate functions, and that the individuals most qualified for a function should be designated to perform that function. The directors of the Foundation Shareholders will be required to deal with a number of complex financial strategy, investment banking and securities law issues, as well as issues concerning analysis and monitoring of charitable grants. The Investment Committee and the Program Committee have very different functions—the Investment Committee is charged with managing and disposing of investments, while the Program Committee is tasked with analyzing and making recommendations with respect to charitable grants,

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70 Blackstone Report at 10.

71 See NYSE Listed Company Manual, Section 303A.02(b)(v).

72 Report of the Corporate Accountability and Listing Standards Committee of the NYSE at 1-2, available at http://www.nyse.com/pdfs/corp_introduction.pdf.

73 C&B Supplemental Report at 32.

programs and other expenditures.[74] The proper operation of each of these committees requires a different set of skills from their respective members.

The functions of these committees are also quite different from those of typical board committees of a for-profit corporation. Many directors of for-profit corporations can, and do, hold multiple committee seats, which is both effective and permissible because committee functions in a for-profit setting are predominantly business functions (e.g., audit, finance, compensation) and nearly all for-profit directors come from a business background and have some familiarity with the various committee functions. The directors of the Foundation Shareholders, by contrast, will need to have one or the other of two very different backgrounds (investment management vs. charitable giving), and it is not likely that many directors will be particularly experienced as to both. As a result, the very specific separation of functions between the two committees seems to be both appropriate and consistent with principles of good corporate governance.

f. *Qualifications of Foundation Shareholders' Committee Members*. The Foundation Shareholders' proposed Bylaws also set forth very specific requirements as to the qualifications of the members of the Investment and Program Committees of their boards of directors. Even though it has been suggested by C&B that such requirements are overly strict and unnecessary,[75] I believe that they are actually quite important to the success of the Foundation Shareholders, as well as to New PREMERA. Unlike many charitable organizations, the Foundation Shareholders will be required to deal with a number of complex financial strategy, investment banking and securities law issues as they seek to optimize their returns from the sale of New PREMERA shares over an extended period of time. The skill sets required to perform the Investment Committee's functions are very different from those required to

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[74] See proposed Bylaws of the Foundation Shareholders, Sections 8.5, 8.6.

[75] C&B Supplemental Report at 32. I believe the C&B has misinterpreted at least one of the provisions set forth in Section 8.5 of proposed Bylaws of the Foundation Shareholders. In the C&B Supplemental Report, C&B states that a requirement for the members of the Investment Committee is that such persons must have "experience with a public company" (at 32). Pursuant to its terms, Section 8.5 state that to be a member of the Investment Committee, a person must "have substantial business or financial management experience, *such as* experience as a board member or executive officer of a public company or other comparable experience." I believe that the basic requirement for a member of the Investment Committee is that such person has "business or financial management experience." Public company experience would, of course, be highly desirable to deal with the complex issues facing the Investment Committee since its principal and most challenging function will be to manage the timing and manner of disposition of New PREMERA shares, a task which could have an undesirable outcome if not optimally managed. However, I do not see in Section 8.5 any requirement that the person's business or financial management experience *must* be with a with a public company.

select and monitor charitable grants. In addition to ensuring that the Foundation Shareholders will have an optimal chance to achieve the charitable objectives that Premera (their settlor) intends, the requirement that highly qualified individuals review and coordinate the Foundation Shareholders' trading activities will also provide comfort to public investors.

g. *Exclusions for Foundation Shareholder Directors*. Section 3.2 of the proposed Bylaws of the Foundation Shareholders sets forth the qualifications and certain restrictions applicable to the potential directors for the Foundation Shareholders. Excluded from eligibility for the Washington Foundation Shareholder's board, according to C&B, are "individuals who are a member 'of any hospital or hospital association or medical association in Washington.'"[76] In the C&B Supplemental Report, C&B states that this exclusion is "extremely troublesome" and "quite puzzling."[77] To me, the only puzzling part is C&B's interpretation of this section. I believe that Section 3.2(i)[78] clearly states that a director of the Washington Foundation Shareholder may not include any director, officer or employee of (i) the BCBSA or one of its licensees, (ii) any hospital or hospital association or medical association in Washington, or (iii) any other entity "engaged in the business of providing coverage or the administration of health benefits…." This language should not be read, as C&B has done, to exclude all *members* of hospitals, hospital associations or medical associations in Washington. The only use of the word "member" in Section 3.2(i) relates to "members" of the board of directors of such organization, which C&B has improperly read to include all members of such organizations.

h. *Delegation of Corporate Power to the Investment Committee*. In the C&B Supplemental Report, C&B voices a concern that the Investment Committee of the Washington Foundation Shareholder is delegated the power, without further approval from the full board of directors, to determine the control and disposition of the Foundation Shareholder's holdings of shares of New PREMERA stock.[79] C&B

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[76] C&B Supplemental Report at 31.

[77] Id.

[78] "[N]o director may be: (i) a member of the Board of Directors, or an officer or employee, of the Blue Cross Blue Shield Association or one of its licensees, of any hospital or hospital association or medical association in Washington, or of any other entity engaged in the business of providing coverage, or the administration, of health benefits, including, without limitation, any health insurer, Health Care Service Contractor (as defined in RCW 48.44.010), hospital and medical service corporation, health maintenance organization, health carrier or health plan in Washington, or any affiliate of any of the foregoing…." Proposed Washington Foundation Shareholder Bylaws, Section 3.2(i).

[79] C&B Supplemental Report at 32, summ. at 14.

argues that the Investment Committee does not have the "expertise" required to "balance the health needs of the Washington public with the maximization of the proceeds…from the disposition of [such shares]."[80] I disagree with this argument. As discussed above, the proper operation of the Investment Committee will require that highly qualified individuals review and coordinate the Foundation Shareholders' trading activities. The skills required to effect these activities are different from the skills required of other directors, and I believe good corporate governance requires that control over the disposition of the New PREMERA shares over a lengthy disposition period be delegated to those board members who are most qualified for this function. Under Washington law, a not-for-profit corporation may delegate nearly all duties of the directors to a committee, including the sale of substantially all of the assets of the corporation in the ordinary course of business.[81] The disposition of New PREMERA shares, by a not-for-profit corporation whose purpose is to gradually dispose of those shares pursuant to contractual obligations imposed at the time of the corporation's creation and receipt of such shares, is clearly a sale "in the ordinary course of business." As a result, the delegation of the responsibility for these investment management activities to the Investment Committee is not only legal, but I believe necessary and advisable as well. Finally, it should be remembered that the members of the Investment Committee will be directors who bear the full complement of fiduciary obligations that apply to all directors. As a result, to the extent that there are indeed "balancing" questions to be taken into account in managing the asset diversification process, they will be required to listen to input from other directors or officers to that effect. Considering the importance of a well-managed portfolio diversification process—not only to the Foundation Shareholders but also to the public shareholders of New PREMERA (who could easily be harmed by a poorly managed portfolio diversification process)—Premera seems to me to be on very solid footing in insisting that the Foundation Shareholders' portfolios be managed by those best qualified to do so.[82]

i. *Creation of a Third-Party Beneficiary*. In the C&B Supplemental Report, C&B states that the Transfer Agreement "inappropriately treats New PREMERA as a third-party beneficiary with the

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[80] C&B Supplemental Report at 32.

[81] RCW 24.03.115.

[82] C&B also objection to the Investment Committee because it is created initially by the First Board, which may not be independent from New PREMERA. This is wholly irrelevant since the Foundation Shareholder will not hold any significant investment assets until after the Proposed Conversion is effective, at which time the First Board, including the members of the Investment Committee, will be replaced by the Second Board.

right to obtain injunctive relief" and that there is "not a credible argument to support Premera's assertion that New PREMERA should be deemed a third-party beneficiary with respect to the funds expended by the Washington Foundation [Shareholder]."[83] The language of Section 3.02(c) of the Transfer Agreement does in my view give New PREMERA enforceable rights as a third-party beneficiary under Washington law.[84]

C&B questions why that is necessary, and whether there is any "credible" basis for affording New PREMERA such enforcement rights. C&B's rhetorical question seems to me to be rather easily answered: New PREMERA has fairly obvious business interests in ensuring that the Foundation Shareholders' grantees abide by the "purpose" restrictions of the Transfer Agreement.[85] Perhaps more importantly, since Premera has not been shown to be subject to charitable transfer restrictions,[86] its decision to dissolve and distribute its assets to the Foundation Shareholder is a voluntary act,[87] as to which it is entitled to impose whatever requirements and limitations it deems appropriate. Since PREMERA itself (the actual donor of the assets) will no longer exist after its dissolution pursuant to the Proposed Conversion, it seems quite sensible to me that it would designate New PREMERA as the continuing corporate entity that has the power to enforce the intended restrictions of the Transfer Agreement.

j. *Required Sale of Shares by the Foundation Shareholders in the New PREMERA Initial Public Offering*. In the C&B Supplemental Report, C&B states that the Unallocated Shares Agreement "causes

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[83] C&B Supplemental Report at 33-35, 85-86.

[84] Under Washington law, the creation of a third-party beneficiary contract requires that the parties intend that the "promisor assume a direct obligation to the intended beneficiary at the time they entire into the contract." Lonsdale v. Chesterfield ("Lonsdale"), 99 Wn.2d 353, 361, 662 P.2d 385, 389 (1983) (citing Burke & Thomas, Inc. v. Int'l Org. of Masters, 92 Wn.2d 762, 767, 600 P.2d 1282 (1979)). Such "intent" to create a third-party beneficiary is found if the "terms of the contract necessarily require the promisor to confer a benefit upon a third person." Lonsdale, 99 Wn.2d at 361 (citing Vikingstad v. Babbott, 46 Wn.2d 494, 496-97, 282 P.2d 824 (1955)). Once a third-party beneficiary is established, such party may enforce the contract to the extent enforceable by the promisee. Kinne v. Lampson, 58 Wn.2d 563, 567, 364 P.2d 510, 512 (1961). By including New PREMERA in the Transfer Agreement and requiring that any recipient of funds from the Foundation Shareholder acknowledge that New PREMERA is an intended beneficiary, the legal requirements are satisfied.

[85] For example, the limitation in Section 1.03(c) of the Transfer Agreement prohibiting use of grant proceeds for actions inimical to healthcare insurers.

[86] See discussion supra notes 32-38 and accompanying text.

[87] See discussion supra notes 36-38 and accompanying text.

concern" because of a requirement "for no apparent reason" that if the Foundation Shareholders do not in the aggregate sell 10% of their shares in the New PREMERA initial public offering, the escrow agent must sell unallocated shares to the extent of such deficiency.[88] I do not share either C&B's concern or its inability to discern the legitimate business reason for this requirement. Under the Voting Trust Agreement, the Foundation Shareholders must collectively reduce their ownership in New PREMERA to less than 80% of New PREMERA's outstanding shares by the end of the first year following the initial public offering. Under Rule 144 promulgated under the Securities Act of 1933, as amended, the Foundation Shareholders will not be able to sell shares into the public market for a period of at least 90 days after the initial public offering closing, which reduces the time period for getting under the 80% ownership level to only nine months. The greater the portion of the Foundation Shareholders' holdings that has to be sold in the open market after the initial public offering, the greater the downward pressure that actual or anticipated selling activity over the 9-month selling window will exert on New PREMERA's stock price in the highly vulnerable trading period following the initial public offering. In order to bring stability to the market for New PREMERA stock, it is reasonable to insist that a certain significant amount of secondary shares be sold in the controlled environment of the initial public offering. In the long run, I believe such stability will benefit both the Foundation Shareholders and the investing public from a financial perspective.

k. *Timing of the Appointment of the Third Board*. In the C&B Supplemental Report, C&B criticizes the timing of the appointment of the Third Board (as defined in the proposed Bylaws of the Foundation Shareholders) as set forth in Section 3.5.2 of the proposed Bylaws of the Foundation Shareholders, on the ground that Premera does not have a "good reason to prevent" appointment of the Third Board by the Attorney General until after New PREMERA's initial public offering.[89] C&B argues that this provision is "inappropriate and raises a fundamental concern regarding corporate governance."[90] I believe there are, however, several good reasons justifying this provision, including: (1) given that the directors who serve on the New PREMERA board at the time of the initial public offering will have personal liability for the contents of the initial public offering prospectus, registration statement and related documents, the directors at that time should have sufficient continuity and knowledge about New

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[88] C&B Supplemental Report at 76; Unallocated Shares Agreement, Section 2.

[89] C&B Supplemental Report at 31-32

[90] Id..

PREMERA and the Proposed Conversion to be comfortable signing the initial public offering documents; (2) from a marketing perspective, the underwriters for the initial public offering will not want to have to deal with the possibility of last-minute changes in board composition after the disclosure and marketing process have commenced; and (3) I see little downside to the Attorney General in delaying appointment of the Third Board, in light of the fact that the Attorney General also appoints the Second Board (as defined in the proposed Bylaws of the Foundation Shareholders).

l. *Extension of Period for New PREMERA Initial Public Offering*. In the C&B Supplemental Report and the Blackstone Report, the OIC Consultants suggest that, while the 12-month period (from the time the OIC and Attorney General have granted their approvals of the Proposed Conversion) for New PREMERA to effect its initial public offering is "adequate" and "not… inherently unreasonable," the two additional automatic three-month extensions if there is pending litigation related to the Proposed Conversion are unreasonable and should be deleted. The OIC Consultants argue that such extensions "greatly increase the probability of material changes between the [OIC's] approval and the IPO," and that the OIC "should be able to review the facts and circumstances to determine if an extension is warranted."[91] Based on my experience with numerous initial public offerings, I consider these criticisms unrealistic and impractical.

An initial public offering is not a simple transaction. After the parties have performed the requisite due diligence, prepared a significant disclosure document, responded to numerous questions and document requests from the Securities and Exchange Commission, and revised and filed numerous amendments to the initial filing, the investment bankers must still market the security in the capital markets, and then a closing is held. This process can take three to four months in a good economy. In a fickle market, the underwriters may delay even commencing the due diligence and drafting processes until the market appears more receptive, and even then the marketing process alone can take months. If there were litigation pending related to the Proposed Conversion, the underwriters would be highly likely to delay their efforts until it was resolved.

Litigation related to the Proposed Conversion, would, of course, be extremely material to potential investors in a public offering, since its outcome could prevent New PREMERA from carrying on Premera's business at all. Because the filing and prosecution of such litigation will be for the most part

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[91] C&B Supplemental Report at 14-15; Blackstone Report at 7.

outside the control of Premera, it seems unfair to penalize Premera by requiring it to seek re-approval from the OIC and the Attorney General if the litigation persists for an additional three or six months after the 12-month period. The OIC's interests are reasonably protected by the fact that the overall extension period is limited to six months, after which Premera must seek re-approval.

Considering the uncertain state of the U.S. economy and capital markets at this time, the 15- to 18-month period reflected in the Plan of Conversion filed as part of the Amended Form A Filing is not, in my view, an unnecessarily long period of time to accomplish the New PREMERA initial public offering, especially if Premera is subject to litigation related to the Proposed Conversion during such period. Furthermore, in light of the number of intervenors in this proceeding, it seems highly inappropriate to augment the leverage they can achieve by filing suit. Eliminating the two automatic extension periods could leave Premera with insufficient time to obtain dismissal of a lawsuit filed on the eve of an initial public offering closing, and could thereby only encourage additional litigation.

m. *Closing of Proposed Conversion and Initial Public Offering*. In the C&B Supplemental Report, C&B expresses concern that the New PREMERA initial public offering must occur logically before the closing of the Proposed Conversion.[92] This is not the way I understand that the transaction will be, and is certainly not how it should be, structured. Under Section 4.3(b) of the Plan of Conversion, the closing of the transaction will occur no more than 12 months (subject to extension) after Premera has received approval from each of the OIC, the Alaska Division of Insurance, the Oregon Insurance Division, the Washington Attorney General, the BCBSA and the Washington Department of Revenue. Once the last of these approvals is received, the 12-month period begins and Premera will begin to prepare itself to effect the conversion transactions and the initial public offering, including selecting underwriters, drafting and filing disclosure documents, and assisting the underwriters in marketing the initial public offering. On or around the day that the initial public offering registration statement is declared effective, all the steps to the Proposed Conversion will be effected, and then newly formed New PREMERA, as well as the Foundation Shareholders, will simultaneously sell a portion of the newly issued shares of New PREMERA stock to the public in accordance with Section 5.3 of the Plan of Conversion. The consummation of the initial public offering is not and cannot be a condition to the consummation of the Proposed Conversion, because the shares of New PREMERA cannot be sold to the public until after (albeit, only a moment after) New PREMERA has received the Premera business assets

[92] C&B Supplemental Report at 14.

and contributed its initial shares to the Foundation Shareholders (so that they can sell a portion of those shares in the offering). The fact that all of the conversion and offering steps will occur simultaneously at the closing will not, as C&B asserts, "handicap" the Foundation Shareholders "from realizing the value of the [s]hares."[93] On the contrary, the Foundation Shareholders would not otherwise have any shares to sell.

Analysis of Amended Transaction Documents under Washington Corporate Law

The OIC Consultants' supplemental reports identify several respects in which, they say, the amended transaction documents filed with the Amended Form A Filing may exceed the limitations of applicable corporate statutes. Without addressing each of these provisions in minute detail, let me simply offer my view that, on the whole, the provisions so criticized are permissible under Washington corporate law.

a. *Nomination of One Director by Foundation Shareholders*. In the Blackstone Report, Blackstone argues that the Washington Foundation Shareholder should have the right to nominate its own representative to the New PREMERA board of directors because it is "important that the Washington Foundation [Shareholder] have appropriate representation" on the board.[94] I believe that this "appropriate" representation can be achieved through the nomination of one director by the Foundation Shareholders, as set forth in Article III, Section 5(f) of the proposed Articles of Incorporation of the Foundation Shareholders, with such director reporting to both of the Foundation Shareholders. Under Washington corporate law, the only restrictions on such reporting relationships—whether to one or a dozen shareholders—are that (i) the director must at all times be sure not to confuse the reporting relationship with the fact that his or her fiduciary duties run to the corporation and all of its shareholders (not just those to whom he or she reports), and (ii) the director must be sure that the confidences of the corporation are maintained, which can be accomplished through a confidentiality agreement executed by the Foundation Shareholders and New PREMERA. As long as these limitations are observed, there is no legal problem with a single director reporting periodically to multiple shareholders. It is unclear to me whether Blackstone, in suggesting that the Washington Foundation Shareholder should have separate "representation" on New PREMERA's board, is proposing that such a separate director would have more than a reporting function, and would in fact be bound in some fashion to do the Washington Foundation

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[93] Id.

[94] Blackstone Report at 8, 19.

Shareholder's bidding as to New PREMERA board matters. If this is what Blackstone is suggesting, then I strongly disagree with the proposal, because (a) it would be inconsistent with the director's duty to represent all shareholders (see clause (i) above), and (b) it would very likely be viewed by the investing public as detracting from good corporation governance.

b. *Release of "Prudent Person" Duties*. In the C&B Supplemental Report, C&B makes the claim that the exemption of the Washington Foundation Shareholder's management from the "prudent person" duty to diversify assets held in a fiduciary capacity is "too broad."[95] Under the Proposed Conversion, the Foundation Shareholders will each hold a concentration of shares of New PREMERA stock, which will begin at 100% of their assets and, depending on how quickly they apply their cash assets to charitable uses, could continue to comprise a very significant percentage of their assets even as they dispose of shares over the next decade or more. Since this concentration of assets is so likely to continue, it is essential that the directors of the Foundation Shareholders not be held to the typical "prudent person" duty to diversify the shares of New PREMERA stock that the Foundation Shareholders will hold. Without a release of this obligation under RCW 11.100.020, as well as from the other statutory requirements specified in the proposed Articles of Incorporation of the Washington Foundation Shareholder,[96] the Washington Foundation Shareholder's directors could be exposed to personal liability for failure to diversify holdings of New PREMERA stock that they have little practical ability to diversify quickly.

Having reviewed these releases as specified in the proposed Articles of Incorporation, I believe that they are narrowly drawn so as to be limited in their application to the board's prudence and diversification duties relative to only the New PREMERA shares to be held by the Washington Foundation Shareholder. Such narrowly drawn provisions are consistent with what I would expect reasonably skilled corporate lawyers to draft in these particular circumstances, to ensure that the directors of the Washington Foundation Shareholder are not held to a standard of care that they may not be able to meet relative to diversification of the New PREMERA shareholdings. These provisions do not, in my view, bear any

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[95] C&B Supplemental Report at 28-30, 84.

[96] Article VII, Section 2 provides that, to the extent that the shares of New PREMERA stock are deemed to be held in trust under RCW Ch. 11.100, the directors of the Washington Foundation Shareholder are released from duties and limitations under RCW 11.100.020 (prudence requirements), 11.100.023 (10% limit on speculative securities), 11.100.045 (duty to beneficiaries), 11.100.047 (duty to diversify), 11.100.060 (duty to exercise due care and prudence in diversification of New PREMERA stock), 11.100.130 (control persons liability), and 11.100.140 (nonroutine transactions).

potential for the Washington Foundation Shareholder's directors to engage in any "imprudent" conduct other than continuing to hold a concentration of New PREMERA shares, and therefore do not raise any public interest concerns. It is worth noting that these releases only relieve the directors from fiduciary duties as "trustees" under RCW Ch. 11.100—they will continue to have a full complement of fiduciary obligations as not-for-profit corporation directors under RCW Ch. 24.03.

c. *Nature of Fiduciary Duties of Premera and New PREMERA Directors*. In his report entitled "Report on the Proposed Conversion of Premera" dated November 7, 2003 (the "Larsen Report") and in his related deposition taken on December 1, 2003, Steven B. Larsen states, among other things, that (i) the absence of "traditional ownership" of a not-for-profit corporation creates "questions and confusion regarding the fiduciary duties of the board and its management," (ii) a not-for-profit corporation's "reason for existence" is not to generate profit, thus creating a duty of its directors to pursue the "charitable purpose or public benefit which is the mission of the corporation," which duty is different from the duty of a director of a for-profit corporation "to maximize long term profit for the benefit of the corporation and the shareholders," (iii) there is a "fundamental difference between the ultimate operational objectives of … nonprofit and for-profit" entities, and (iv) not-for-profit corporations "'are directly responsible and accountable to the communities and populations they serve, and are legally and ethically bound to do 'good' for the benefit of their communities.'"[97] I generally disagree with these assertions.

Directors of for-profit and not-for-profit corporations have essentially the same standard of care under Washington law—a director of each type of corporation in Washington must discharge his or her duty in good faith, in a manner the director reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person in a like position would exercise under similar circumstances.[98] In each case, these duties look to the "best interests of the corporation" and not to the best interests of the shareholders or any other particular group of stakeholders.

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[97] Larsen Report at 6-7 (quoting Summers v. Cherokee Children & Fam. Serv., Inc., 2002 WL 31126636 (Tenn. Ct. App. 2002); and Metcalf, "Advancing the Role of Nonprofit Health Care," *Inquiry* (Summer 2002)).

[98] Under RCW Ch. 24.06, the statute under which PREMERA is organized, each of PREMERA's directors must discharge his or her duty "(a) [i]n good faith; (b) [w]ith the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (c) [i]n a manner the director . . . reasonably believes to be in the best interests of the corporation." RCW 24.06.153(1). Under RCW Ch. 24.03, the statute under which Premera BC is organized, each director of Premera BC must perform his or her duties "in good faith, in a manner such director believes to be in the best interests of the corporation, and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances." RCW 24.03.127. Under RCW
(footnote continued on next page)

In addition, directors of a not-for-profit corporation that operates a commercial business, such as Premera and New PREMERA, generally have the same mix of objectives as directors of a for-profit corporation operating a similar business. This mix of objectives includes achieving and maintaining profitability, remaining competitive and viable, ensuring that the corporation has adequate capital, pursuing growth, and addressing the needs of the various constituencies of the business (e.g., vendors, employees, customers). This is not to say that there are no situations where the objectives of directors in the for-profit and not-for-profit contexts may diverge. For example, a director of a not-for-profit corporation charged with expending a charitable endowment may have the objective, in acting in the "best interests of the corporation," to focus primarily on the intended beneficiaries, with significantly less attention to rates of return, business growth or competitiveness. By contrast, where a not-for-profit and a for-profit corporation conduct the same business operations which are inherently commercial in nature, there is very little divergence—the goals in both situations are to maximize rates of return, business growth and competitiveness.

Normally, neither for-profit nor not-for-profit corporations' directors are *legally* obligated to maximize value for stakeholders. In the absence of "Revlon" duties,[99] a board of a for-profit corporation (i) is not required to sell the business in an effort to maximize short-term value for shareholders, (ii) is permitted to pursue alternate structures or transactions designed to create long-term value for shareholders, (iii) is not required to focus solely on financial value, and (iv) may take into account the best interests of other "constituencies" of the business. Only in a "Revlon" scenario is a board of directors required to maximize short-term value for shareholders. But even in the few very unusual Revlon scenarios, there is no fundamental difference in duties of directors of a commercial business arising out of its for-profit or not-for-profit status—both are required in a Revlon setting to abandon their focus on the long term and multiple constituencies, and narrow their efforts down to maximizing dollar value in the short term.

Neither for-profit nor not-for-profit corporations are otherwise obligated to maximize value for shareholders or other stakeholders. Nor is it necessarily true that directors of a public company will be

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Ch. 23B, the for-profit corporation statute, each director must discharge his or her duties "in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances and in a manner the director reasonably believes to be in the best interests of the corporation." RCW 23B.08.300(1)

[99] See discussion at pp. 5-8 of my Initial Report. See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc. ("Revlon"), 506 A.2d 173 (Del. 1986). See also, e.g., Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1989); Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34 (Del. 1993).

forced to do so by market or other practical considerations.[100] Contrary to Mr. Larsen's assertions, I believe that the best run companies do not try to maximize short term stock price. Instead, they strive to maximize long-term growth and to ignore market pressures to operate on a quarter-by-quarter basis.

As applied to the Proposed Conversion and Premera, if the conversion is not approved, I believe it is reasonable to expect that Premera will continue doing what is necessary to optimize profit and augment capital. Premera currently has significant outside pressure to increase profits and retained capital (e.g., pressures from risk-based capital requirements monitored by the state, rating agencies and the BCBSA). In addition, because Premera is limited in its available capital, and has really only one effective means for increasing its capital (as long as it remains not-for-profit), it is reasonable to conclude that it may at some point consider it necessary to increase premiums, cut back on provider reimbursements and/or drop unprofitable product lines. Because Premera is essentially running a commercial business that competes against for-profit corporations, Mr. Larsen's conclusion that Premera would be in a position to cross-subsidize unprofitable product lines any time soon (if ever) seems illusory.[101]

On the other hand, if the Proposed Conversion is approved, I believe it is reasonable to expect that Premera will do what is necessary to expand its market share. In this situation, Premera would no longer be under pressure to increase its capital. In addition, by virtue of having increased its capital through the initial public offering, New PREMERA would be in a position to increase its subscriber base and market share, activities on which its analysts will also be focused. As a public company, any attempt to raise rates or reduce provider reimbursements, as suggested by Mr. Larsen, would be in tension with New PREMERA's stated objectives of increasing market share and maintaining a broad provider network. In summary, I believe that a for-profit, well-capitalized New PREMERA may actually be under less pressure to maximize near-term profits than a continuing undercapitalized not-for-profit Premera.

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[100] See Larsen Report at 11-14.

[101] See Larsen Report at 8.

Schedule A

Materials Reviewed

1. Amended Form A (Statement Regarding the Acquisition of Control of a Domestic Health Carrier and a Domestic Insurer), filed by New PREMERA with the OIC on February 5, 2004;

2. Supplementary materials filed by New PREMERA as part of the same Amended Form A submission on February 5, 2004;

3. Supplemental report from C&B concerning the Amended Form A Filing, dated February 27, 2004;

4. Legal Opinion dated January 16, 2004 from C&B to the Deputy Insurance Commissioner of the State of Washington;

5. Legal Opinion dated February 19, 2004 from C&B to the Deputy Insurance Commissioner of the State of Washington;

6. Update Report of The Blackstone Group to the OIC as to valuation and fairness issues relating to the Proposed Conversion, dated February 27, 2004;

7. Deposition Upon Oral Examination of Patrick H. Cantilo, taken December 2, 2003;

8. Letter from Robert B. Mitchell, Attorney, Preston Gates & Ellis LLP, to John F. Hamje, AIRC, Staff Attorney, Legal Affairs Division, OIC, dated October 15, 2003;

9. Letter from H.R. Brereton Barlow, Chief Executive Officer, and Yori Milo, Executive Vice President, Chief Legal & Public Policy Officer, of Premera, to Honorable Christine O. Gregoire, Washington Attorney General, dated May 30, 2002;

10. Report on the Proposed Conversion of Premera dated November 7, 2003, from Steven B. Larsen;

11. Deposition Upon Oral Examination of Steven B. Larsen, taken December 1, 2003; and

12. Each of the items set forth on Schedule A to the Initial Report.